

# COMPASS

## Compass Special Report

### The Credit Crisis

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With Wall Street occupying the front page of our newspapers, it may be tempting to conclude that the financial crisis just hit the municipal bond markets as well. Actually, in the municipal bond markets, we are passing the first anniversary of what has now become a worldwide fiscal crisis. In the fall of 2007, the rating agencies began questioning the credit ratings of bond insurers, citing their exposure to securitized sub-prime mortgages. By expressing doubt and eventually downgrading certain bond insurers, a chain of events was unleashed that alone would have been sufficient to rock the world of municipal finance. But as the same credit analysis was applied to more and more financial institutions, the sub-prime mortgage crisis contributed to a global market collapse and the onset of recession, pushing public finance into truly uncharted territory.

In the month following the Lehman Brothers bankruptcy and AIG bailout, many of the institutions that had been big investors in municipal bonds (including many "hedge" funds), found they had to sell-off their municipal holdings, either because of the lower ratings due to the bond insurer downgrades or to offset losses in other assets. As a result, demand for municipal bonds was down at the same time as the supply, created by current holders trying to sell-off their inventory, was up. Interest rates on the limited amount of tax-exempt paper that was traded rose 130 basis points in

just 30 days. The ratio of tax-exempt bond rates to treasuries reached an unprecedented 135%. Municipal bonds typically trade at 80% of treasuries, since interest earned on them is tax exempt, so it is particularly striking when the taxable securities bear the *lower* interest rates. This exploding ratio of rising tax-exempt rates versus treasuries reflects the drying up of demand for municipals, and the flight to quality, bringing treasury rates down to absurdly low levels.

Following a \$700 billion U.S. bailout, \$1 trillion in European bank support, federal takeovers of Fannie Mae and Freddie Mac and private insurance companies, and talk of a new economic stimulus package, there finally may be some light on the horizon. Just recently, short-term bank rates have started to return to reasonable levels. The tax-exempt market, after coming close to shutting down completely, is starting to see some new product. The State of California sold \$5 billion in cash flow notes, albeit at high rates, mostly to retail investors. In the following weeks, tax-exempt rates began a dramatic fall, and a loud, collective sigh of relief was heard in most corners of the industry.

The landscape is littered with casualties. Of the 8 largest underwriters of municipal bonds in 2007, only four

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are expected to be active by 2009: Citi, Goldman, Morgan Stanley, and JP Morgan. Both Lehman Brothers and Bear Stearns have already disappeared, Merrill is about to be absorbed into Bank of America, and UBS just walked away from public finance altogether.

A worse fate appears waiting for bond insurers. While bonds issued with bond insurance represented up to 80% of the California market in years past, it is now virtually non-existent. Of the nine "AAA" insurers of last year, all but two have fallen below that threshold required for business. The survivors—FSA and Assured Guarantee—are both on negative credit watch and virtually ignored by the market. Only Berkshire Hathaway attracts market interest, and they are proceeding very cautiously into our market, and very expensively from the issuer's perspective.

### Near-Term Impact on Public Finance

Time will tell whether we are at the beginning of recovery or only in the eye of the storm. But even in unprecedented times, municipal issuers must make decisions. The following are some observations that may help in that process.

- Interest rates have been inflated due to muted investor demand, as institutional investors stood on the sideline and increased supply, and large institutions and structured bond investors (think hedge fund and tendered option programs) liquidated their holdings.
- Rates have been pressured not only by real supply, but also by a tidal wave of growing backlog, both from expectations of more institutional portfolio purging and from a growing list of new money issuers who are holding back. As of this writing, the visible supply, or planned issuance of muni bonds, was nearing \$20 billion.

- A question we often hear from issuers today is: "Go now or wait?" Even in the best of times, the future is unpredictable. But the potential costs of pricing now, or the risks of pricing later, are both unattractive. Up to now, most deals have been put on hold. As the market thaws, financings for projects that cannot be deferred (or for which the cost of deferral is high) will probably come to market. In general, KNN's clients have continued to queue up new transactions, knowing that the decision as to market timing can be revisited week by week, even day by day.

- There has been some speculation by market participants that the market would shift in favor of negotiated sales over competitive. We believe it is premature to reach such conclusions and, in fact, think the competitive market will remain viable. On October 30, 2008, we sold a TRAN for Sonoma County and received 5 bids, with rates that went well lower than expectations. Our sister office in Utah received nine bids on a small general obligation bond issue that was bank qualified. Of course, the market has only begun to regain its footing, and every transaction should be evaluated to determine the most appropriate method of sale in the market at that time.

- We feel that one of the few true bright spots in this market has been bank qualified (BQ) bonds, smaller transactions of issuers who certify that they will sell no more than \$10 million in tax-exempt bonds in the year of issue. While there have been times when the spread between BQ and non-BQ bonds was imperceptible, recently spreads have been as wide as 100 basis points. Issuers who could split a \$20 million financing into two \$10 million transactions, with the first closing before December 30, may have some opportunities to reduce borrowing cost.

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- Variable rate issues—including those that had been synthetically “fixed” with swaps—have been hammered all year. After years of growing penetration by bond insurers into the variable rate market, these programs were the first casualties of bond insurer downgrades. The sudden erosion of ratings was followed by an erosion of investor confidence in the entire insured variable rate market. Even credits with strong underlying ratings have seen rates spiking to maximum levels and paper put back by investors to liquidity banks. And while the broker-dealers became increasingly unwilling to inventory variable rate bonds, ratings on many of the credit and liquidity banks began to fall, and new liquidity dried up. Issuers who had been moving their variable rate debt programs around like chess pieces found themselves trapped without viable options besides accepting interest rates as high as 10%.
- Adding insult to injury, the market crisis is coexisting with (caused by or causing, you be the judge) a major recession. Public revenues are down or threatened: home values falling, delinquencies rising, and sales tax declining. Local pressures may be exacerbated by California’s budget challenges. At least in the past economic downturns, California has diverted local revenues to meet its own budgetary need.

- In the midst of all the confusion, rating agencies have declared their intention of raising municipal ratings to better correspond to equivalent corporate ratings. While it is not clear the affect that such “globalization” of the rating scale would have had, both Moody’s and Fitch have put their projects on hold. Apparently, they are second guessing the decision to undertake a wholesale upgrade of credit ratings during the most serious credit crisis of our lifetimes.

As Halloween recently reminded us, times are certainly scary. But KNN remains dedicated to working with public agencies as we pass through this darkness, together ensuring that the business of financing the public’s business continues.

Disclosure: This newsletter was produced for KNN Public Finance’s clients as an informational resource. The opinions expressed herein are those of the authors, which are not necessarily those of KNN Public Finance.



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